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In the Supreme Court of the United States

OCTOBER TERM, 1951

No. 633

E. FIELD WHITE, *Petitioner*

v.

JOHN J. FITZPATRICK,
As Collector of Internal Revenue
for the District of Connecticut

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit

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BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the District Court (R. 93a-99a) is not as yet officially reported. The opinion of the Court of Appeals (R. 103-109), together with the dissenting opinion (R. 110-112), is reported at 193 F. 2d 398.

JURISDICTION

The judgment of the Court of Appeals was entered on December 10, 1951. (R. 112-113.) The

petition for a writ of certiorari was filed March 6, 1952. The jurisdiction of this Court is invoked under 28 U.S.C., Section 1254 (1).

QUESTION PRESENTED

Whether the court below erred in holding that taxpayer is not entitled to deductions under Section 23 (a)(1)(A) of the Internal Revenue Code for the amounts he paid to his wife as royalties and rent under gift and leaseback arrangements.

STATUTE INVOLVED

Internal Revenue Code:

> SEC. 23 [as amended by Sec. 121 (a), Revenue Act. of 1942, c. 619, 56 Stat. 798]. DEDUCTIONS FROM GROSS INCOME.
>
> In computing net income there shall be allowed as deductions:
>
> (a) *Expenses.*—
>
> (1) *Trade or business expenses.*—
>
> (A) *In general.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business; and

rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

* * *

(26 U.S.C. 1946 ed., Sec. 23.)

STATEMENT

The material facts as found by the District Court (R. 83a-92a) may be summarized as follows:

Taxpayer is a resident of West Hartford, Connecticut, and the husband of Madge B. White. During the taxable years (1941-1944, inclusive) he was engaged in Tariffville, Connecticut, in the business of manufacturing a device known as a "poly choke" for use on the barrel of a shotgun. He carried on this business under the name of the Poly Choke Company, of which he was sole proprietor. He developed the "poly choke" invention about 1932 and by 1937 was producing it commercially. (R. 83a.) He obtained a United States patent on it on December 27, 1932. (R. 84a.)

On January 21, 1941, taxpayer assigned to his wife, for a stated consideration of $10, his entire right, title and interest in and to the poly choke patent. On the following day, January 22, 1941, taxpayer's wife granted taxpayer, doing business as the Poly Choke Company, the exclusive non-

transferable license to make, to have made for him, and to sell the patented devices under the poly choke patent, with the right to grant sub-licenses to others to make and to sell, to the full end of the entire term of the poly choke patent. (R. 84a-85a.) Under the license (R. 85a-87a) taxpayer was to pay his wife a royalty of $1 for each and every poly choke device made and sold by him or for him or a sub-licensee. (R. 86a.)[1]

Taxpayer filed a gift tax return for 1941 in which he reported the gift of the poly choke patent to his wife and declared the fair market value thereof at that time to be $10,000. The patent assignment was not recorded in the United States Patent Office until 1946. (R. 87a.)

During the calendar years 1941 to 1944, inclusive, taxpayer paid to his wife the amounts shown below as payments of royalty under the license agreement of January 22, 1941 (R. 88a):

Year	*Amount*
1941	$22,390.00
1942	14,183.00
1943	10,000.00
1944	13,094.00

These amounts were reasonable in amount as royalty payments under the license agreement. (R. 88a.)

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[1] The agreement was subject to cancellation by the wife under certain circumstances. (See R. 87a.)

From November 1, 1939, to December 27, 1940, taxpayer occupied for business purposes a tract of approximately 20 acres of land with three factory-type buildings, a garage and an office building situated thereon in the town of Tariffville, Connecticut, under a lease from the Tariffville Lace and Manufacturing Company, by the terms of which he had a nontransferable option to purchase the property for the sum of $15,370. (R. 88a.)

On December 27, 1940, when taxpayer's lease to the Tariffville property had 10 months to run, taxpayer's wife paid $16,800 to the Tariffville Lace and Manufacturing Company as the purchase price of that property. On the following day taxpayer transferred to his wife $16,175. (R. 88a.) After December 27, 1940, and during each of the calendar years 1941 to 1944, inclusive, taxpayer continued to use and occupy this property for business purposes in the manufacture of the poly choke devices. (R. 88a.)

During each of the calendar years 1941, 1942, and 1943 taxpayer, without a written lease, paid to his wife the sum of $1,536 as rent for the use and occupancy of the property. During the first 11 months of 1944 he paid his wife a total of $1,408 for the same premises and in December of that year, following a discussion of the cost of repairs to the roof of one of the buildings, paid his wife $5,000 as an adjustment of rent for the premises. The amounts so paid as rent were reasonable

rentals for the property during those periods. (R. 89a.)

Taxpayer filed timely income tax returns for the years 1941 to 1944, inclusive, in which, in computing his net income, he took deductions for the amounts he paid to his wife for what he claimed and now claims to be royalties on the poly choke patent and rent on the real property. His wife reported as income the amounts paid to her by taxpayer as claimed royalties and rent. (R. 89a-90a.)

After investigation and audit of taxpayer's books, the Commissioner determined deficiencies against taxpayer based in part upon the disallowance of (1) $4,872 of the amount claimed by taxpayer as a payment of rent to his wife in 1944, and (2) the entire amounts claimed by taxpayer as payments of royalties to his wife in 1941 to 1944, inclusive. Taxpayer paid the deficiencies, with interest, and subsequently filed claims for refund and brought suit to recover those portions of the deficiencies attributable to the Commissioner's disallowance of the deductions claimed as payments of royalties and rent to his wife. (R. 89a-91a.)

In making the assignment of the patent to his wife and in giving her the money to make good the purchase price of the property on which he held an option, taxpayer was motivated by a desire to make good losses his wife had suffered in her inherited estate and to minimize the income taxes upon his family group. The relations between taxpayer and

his wife were most friendly and it was taxpayer's expectation that no action would be taken by his wife in the exercise of her rights of ownership of the patent or real property which would be detrimental to his interests. (R. 91a-92a.)

The District Court dismissed taxpayer's action on the merits (R. 100a), upholding the Commissioner's action in respect of the deductions on the ground that the transfers of the patent and real property to taxpayer's wife were not effectual for tax purposes (R. 93a-99a). The Court of Appeals affirmed on the same ground (R. 103-109), with one judge dissenting (R. 110a-112a).

ARGUMENT

This case involves the recurring question of whether a reallocation of income within a family group effected by means of an intra-family gift and leaseback arrangement is to be given effect for tax purposes. The general question is an important one and there appears to be a difference in basic approach to it between the court below and the Seventh and Third Circuits. See *Skemp* v. *Commissioner*, 168 F. 2d 598 (C.A. 7th), and *Brown* v. *Commissioner*, 180 F. 2d 926 (C.A. 3d), certiorari denied, 340 U.S. 814, in each of which the result reached was opposite to that reached in the instant case. However, there are factual differences between those cases and the present case. Regardless of whether those decisions were correct or not, the facts of the present case amply justified

the result reached by the court below. Accordingly, further review of the case by this Court appears unnecessary.

1. Contrary to taxpayer's contention (Pet. 10-12, 13-14), the court below has properly applied to the facts of this case principles established by decisions of this Court.

Section 23 (a)(1)(A) of the Internal Revenue Code (*supra*, pp. 2-3) allows as a deduction from gross income the ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business, including rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity. Contrary to taxpayer's intimation (Pet. 10-11), in determining whether expenditures are ordinary and necessary business expenses, it is not necessary to ignore "the way" in which they became necessary. Indeed, this Court stated in *Deputy* v. *du Pont*, 308 U.S. 488, that "The fact that an obligation to pay has arisen is not sufficient" (p. 496)—that "it is the origin of the liability out of which the expense accrues which is material" (p. 494).

In considering the origin of the liability, mere form is of no importance. This Court has repeatedly stated that taxation is an intensely practical matter concerned with economic realities rather

than with legal title and legal technicalities;[2] that tax consequences flow from the substance of a transaction rather than from its form;[3] that family arrangements are particularly subject to close scrutiny;[4] and that in applying these principles the formal, legal acts taken by a taxpayer may properly be viewed as steps in a single transaction and the legal effect of each step ignored in favor of the substance of the arrangement as a whole.[5] These principles are applicable to, and have been applied by, the Courts of Appeals in a variety of situations, including cases in which claim was made for a business expense or other deduction.[6]

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[2] *Helvering* v. *Clifford*, 309 U.S. 331; *Helvering* v. *Stuart*, 317 U.S. 154; *Harrison* v. *Schaffner*, 312 U.S. 579; *Douglas* v. *Willcuts*, 296 U.S. 1; *Corliss* v. *Bowers*, 281 U.S. 376; *Burnet* v. *Wells*, 289 U.S. 670.

[3] *Commissioner* v. *Court Holding Co.*, 324 U.S. 331; *Higgins* v. *Smith*, 308 U.S. 473; *Griffiths* v. *Commissioner*, 308 U.S. 355; *Gregory* v. *Helvering*, 293 U.S. 465; *Weiss* v. *Stearn*, 265 U.S. 242; *United States* v. *Phellis*, 257 U.S. 156; *Gulf Oil Corp.* v. *Lewellyn*, 248 U.S. 71; *Southern Pacific Co.* v. *Lowe*, 247 U.S. 330.

[4] *Helvering* v. *Clifford*, *supra*; *Commissioner* v. *Tower*, 327 U.S. 280.

[5] *Commissioner* v. *Court Holding Co.*, *supra*; *Commissioner* v. *Tower*, *supra*; *Gregory* v. *Helvering*, *supra*; *Higgins* v. *Smith*, *supra*; *Griffiths* v. *Commissioner*, *supra*; *Helvering* v. *Clifford*, *supra*; *Helvering* v. *Stuart*, *supra*; *Corliss* v. *Bowers*, *supra*.

[6] Thus, business expense deductions have been denied for payments which were labeled as rent or as other expenses or

In the present case, what taxpayer claims were obligations to pay his wife "royalties" on the poly choke patent and "rent" on the real estate had their origin in taxpayer's transfer to his wife of legal title to the patent and in what was in effect a purchase of the real estate by him and transfer of legal title thereto to his wife. The inquiry is necessarily as to the substantive and economic effect of such arrangements. In that connection, as this Court stated in *Commissioner* v. *Sunnen*, 333 U.S. 591, 604, "It has long been established that the mere assignment of the right to receive income is not enough to insulate the assignor from income tax liability." Accordingly, if the arrangements resulting in taxpayer's payment of "royalties" and "rent" to his wife had the substantive and economic effect merely of assignments of the right to receive income, taxpayer's payments of the "royalties" and "rent" constituted gifts to his wife of income on which he was taxable and there-

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deductible items but were in reality dividend distributions. See *Stanwick's, Inc.* v. *Commissioner*, 190 F. 2d 84 (C.A. 4th); *W. H. Armston Co.* v. *Commissioner*, 188 F. 2d 531 (C.A. 5th); *Ingle Coal Corp.* v. *Commissioner*, 174 F. 2d 569 (C.A. 7th); *Limericks, Inc.* v. *Commissioner*, 165 F. 2d 483 (C.A. 5th); *Paramount-Richards Th.* v. *Commissioner*, 153 F. 2d 602, 604 (C.A. 5th); *Regensburg* v. *Commissioner*, 144 F. 2d 41 (C.A. 2d), certiorari denied, 323 U.S. 783; *Illinois Agricultural Hold. Co.* v. *Commissioner*, 131 F. 2d 583 (C.A. 7th).

fore were not deductible as ordinary and necessary expenses of his business.[7]

It is well settled that, despite the transfer of legal title to property and payment of income from it to the transferee, the result is merely a gift of the income if the transferor remains the real owner of the property. *Helvering* v. *Clifford*, 309 U.S. 331; *Commissioner* v. *Sunnen*, 333 U.S. 591; *Commissioner* v. *Culbertson*, 337 U.S. 733. It is equally well settled that the retention of sufficient power and control over the property makes the transferor the real owner of the property. *Commissioner* v. *Sunnen*, 333 U.S. 591. It is further established that, in determining whether the transferor has retained sufficient power and control to warrant treating him as the owner of the property, consideration should be given the informal and indirect benefits to the transferor arising from the fact that the parties are intimately related. *Helvering* v. *Clifford*, 309 U.S. 331; *Commissioner* v. *Sunnen*, 333 U.S. 591, 605.

The decision below correctly applies these principles to the facts of this case. The fact that taxpayer's wife held legal title to the patent (by as-

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[7] As the court below stated (R. 107):

> Plaintiff here, for example, accepts as his own the income he has received on the patent equivalent to the royalties he is paying his wife, but then seeks to deduct it as a business expense; in effect this is not different from claiming that the gift itself made the original income hers in the first place.

signment from taxpayer) and to the real estate (by purchase by the wife and gift of substantially the full purchase price to her by taxpayer) cannot be divorced from the rest of the whole arrangement. Nor did taxpayer intend them to be, for he admitted the impossibility of conducting the business without this basic patent or of finding a comparable factory site in Connecticut. While making gifts to his wife, he retained administrative control over the patent and real property. The court below was correct in stating (R. 107) that the *Clifford* rule is clear that this direct control, when fused with the indirect control which must be implied from a formal but insubstantial assignment within the closed family group displaying no obvious business purpose, renders the assignments ineffective for tax purposes.[8] As the court below stated (R. 109), there is in this case no evidence of a potential exercise of control and management on

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[8] It may be noted that the District Court found as a fact that it was taxpayer's expectation that his wife would take no action in the exercise of her rights of ownership which would be detrimental to his interests (R. 91a-92a) and stated in its memorandum opinion that (R. 95a-96a)—

> And in addition it may be assumed that, owing to the marital relationship, he had a degree of control, not readily measurable in legal terms, over the patent and license agreement. It is not to be thought, in the light of Mr. White's testimony, that his wife would have been unwilling to submit to any alteration or modification of the existing arrangement which he might deem expedient. As he put it, he "owns the wife."

the part of taxpayer's wife, only of passive acquiescence to the will of taxpayer. Taxpayer urges that his dominion and control were only as licensee (Pet. 11), but the circumstances belie such a conclusion which, in any event, is based on the bare fact that, as a result of the arrangements, legal title to the patent and real estate reposed in taxpayer's wife. The court below was accordingly correct in concluding (R. 106) that the sole practical effect of the transactions involved here was to create a right to income in taxpayer's wife, while leaving untouched in all practical reality the husband-donor's effective dominion and control over the properties in question.

2. Taxpayer asserts that the decision below is in conflict with *Skemp* v. *Commissioner*, 168 F. 2d 598 (C.A. 7th), and *Brown* v. *Commissioner*, 180 F. 2d 926 (C.A. 3d), certiorari denied, 340 U.S. 814. We believe that in those cases the Seventh and Third Circuits erred in exalting form over substance, and that there is, accordingly, a conflict in basic approach between the decision below and the *Skemp* and *Brown* decisions. However, the factual situations presented in the *Skemp* and *Brown* cases differed from that here in that the transfers there involved were to trustees, and were for that reason considered by the court below to be "sufficiently outright, to be distinguishable from our present case." (R. 107.)

3. There is no basis for taxpayer's assertion (Pet. 8) that the decision below illustrates a sharp split of opinion existing within the Second Circuit. The Second Circuit decisions cited by taxpayer (*Wodehouse* v. *Commissioner*, 177 F. 2d 881; *Johnson* v. *Commissioner*, 86 F. 2d 710), as well as *Henson* v. *Commissioner*, 174 F. 2d 846 (C.A. 5th), also cited by taxpayer, all involved altogether different factual situations. The court below itself distinguished the *Wodehouse* case on the ground it involved a completed assignment of a created product rather than a gift with retained control. (R. 106.)

4. Taxpayer inferentially urges the importance of the question presented as a ground for granting the writ. (See Pet. 14-15.) We also urged the importance of the general question as a ground for certiorari in our petition for certiorari in the *Brown* case (No. 90, 1950 Term) and certiorari was denied. Contrary to our expectation, the *Skemp* and *Brown* cases have not to date been followed by other courts. As in the instant case of a gift and leaseback, sale and leaseback arrangements have been held not to result in deductible business expenses under Section 23 (a)(1)(A). See *W. H. Armston & Co.* v. *Commissioner*, 188 F. 2d 531 (C.A. 5th); *Shaffer Terminals, Inc.* v. *Commissioner*, 16 T.C. 356, affirmed *per curiam* March 3, 1952 (C.A. 9th) (1952 P-H, par. 72,330); cf.

Ingle Coal Corp. v. *Commissioner*, 174 F. 2d 569 (C.A. 7th).

CONCLUSION

The decision below is correct and there is no real conflict of decisions. The petition for a writ of certiorari should therefore be denied.

Respectfully submitted,

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